In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 159

B & L FARMS CO., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner[1] successfully operated a business of growing and packing produce through July 31, 1956, the end of its 1956 tax year. Thereafter petitioner incurred losses. On August 1, 1958, the first day of its 1959 tax year, petitioner sought and was granted an arrangement under Chapter XI of the Bankruptcy Act. In June 1959 petitioner was adjudicated a bankrupt.

Petitioner argues: 1) the arrangement or bankruptcy proceedings entitled petitioner—a cash basis

[1] "Petitioner" refers to B & L Farms Company. The other petitioners are trustees in bankruptcy of B & L Farms, who will receive any refund to which B & L Farms may be entitled. *Segal* v. *Rochelle*, 382 U.S. 375.

taxpayer—to claim on its 1959 tax return a deduction in the full amount of its outstanding trade indebtedness at the beginning of its 1959 tax year, including amounts not paid until after that year; 2) if petitioner remained a cash basis taxpayer then the transfer of its assets to the trustees in bankruptcy either constituted payment of petitioner's trade debts or constituted a deductible loss; and 3) the permanent suspension of its business operations entitled petitioner to an obsolescense deduction on its building and machinery.

Petitioner's trustees in bankruptcy claimed the deductions, and sought to carry back the resulting loss as a set off against petitioner's 1956 profits. The Commissioner allowed petitioner to deduct only those trade debts that were in fact paid during the 1959 tax year, and a matching carryback against the 1956 profits.[2] The other deductions were disallowed.

Petitioner then sued in the district court for a refund of the remaining $162,538.73 of its 1956 income tax.[3] The district court sustained the Commissioner's action; the Court of Appeals for the Fifth Circuit affirmed, Judge Brown dissenting.

The result below is in accord with the settled state of the law, and there is no occasion for further review.

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[2] Although further deductions would have been allowed and were claimed in later years when the trade debts were paid and the building and machinery sold, losses in those later years could not be set off against the 1956 losses because of the three-year statutory limitations period.

[3] Allowance of any of one of petitioner's claims would have resulted in a sufficient increase in petitioner's 1959 loss to consume the balance of the 1956 profits (R. 43).

1. Petitioner's claimed deduction of the amount of its unpaid trade debts on its 1959 return now rests principally on the theory that either the Chapter XI arrangement or the adjudication in bankruptcy transformed petitioner from a cash basis to an accrual basis taxpayer.[4] Nothing in the Bankruptcy Act allows such a result—which would be contrary to the accounting requirements of the Internal Revenue Code.

From its incipiency in 1949 until the institution of arrangement and then bankruptcy proceedings during its 1959 tax year, petitioner kept its books on a cash basis. Petitioner, as Section 446(a) of the Internal Revenue Code of 1954 requires, computed its taxable income on the same cash basis. Thus, petitioner could deduct a business debt such as those here in issue only in its return for the tax year during which the liability was liquidated in cash or its equivalent. *E.g., Helvering* v. *Price,* 309 U.S. 409, 413; *P. G. Lake, Inc.* v. *Commissioner,* 148 F. 2d 898, 900 (C.A. 5), certiorari denied, 326 U.S. 732; see Internal Revenue Code of 1954, Section 461(a).

Congress has provided a procedure for changing tax accounting methods, which the Commissioner has implemented through regulations. Section 446(e) of the Code is the only statutory provision that allows an overall change in the accounting method used to compute taxable income. That section requires "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books" to "secure the consent of the Secretary or his delegate" "before computing his tax-

[4] Petitioner first advanced this theory in the court of appeals.

able income under the new method * * *." Section 481(a)(2) requires that any change in tax accounting method take into account such adjustments as are necessary to avoid duplication or omission of items of expense or income. Section 1.446-1(e)(3) of the Treasury Regulations on Income Tax (1954 Code) requires that any application for consent to a change in method be filed within the first 90 days of the tax year for which the change is desired. That regulation also requires as a prerequisite of consent to a change of method that the Commissioner and the taxpayer agree to the adjustments required by Section 481 and other Code provisions.

Neither petitioner nor its trustees in bankruptcy made any attempt to comply with this statutory scheme. Petitioner rather relies on a claim that "after the Chapter XI proceeding was filed * * * the accounts payable for these trade creditors * * * simultaneously become accrued" (Pet. 27)—in substance a claim that the nature of arrangement and bankruptcy proceedings required that petitioner keep its books on an accrual basis.

But even if a change in bookkeeping methods resulted for bankruptcy purposes,[5] a change in tax accounting methods did not automatically follow. The change could not apply to petitioner's tax accounting unless there was adherence to Section 446(e) and 481(a) of the 1954 Code, and the resulting regulations.

[5] It is doubtful in any event that bankruptcy proceedings caused petitioner to use the "accrual method" that Section 446(c)(2) of the 1954 Code allows for tax accounting purposes. The most that can be said is that a trustee in bankruptcy must schedule accounts receivable and payable for all inter-

Nothing in the Bankruptcy Act determines the question of the bankrupt's tax accounting method. But Congress, in the Internal Revenue Code, has defined the duties trustees have in fulfilling the obligations of bankrupt corporations under the tax laws. Section 6012(b)(3)—which petitioner ignores—requires that a trustee in bankruptcy of a corporation "make the return of income for such corporation in the same manner and form as corporations are required to make such returns." Thus, all of the requirements that law imposed upon petitioner, including the method of tax accounting and the manner of changing that method, applied with equal force to petitioner's trustees. See *United States* v. *Sampsell*, 266 F. 2d 631 (C.A. 9) (basis for property in hands of trustees was bankrupt's adjusted basis and not market value on the date of transfer to the trustee).

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ested parties and the bankruptcy court to see and act upon. But, the amounts that will in fact be paid out depend on the filing and proof of claims, and the ability of the trustees to reduce receivables to cash or the equivalent. Under the accrual method "deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy." Treasury Regulations on Income Tax (1954 Code), Section 1.446-1(2)(c)(ii). At the time the schedules are filed there is no certainty as to the ultimate amount of the liabilities to be liquidated or the percentage of dividend that will be paid, and that dividend is the limit of the bankrupt's legal liability in the bankruptcy proceedings. Thus there is no accounting basis for treating the trade debts as "accrued" merely because of the filing of schedules with the bankruptcy court. Petitioner notably claims a deduction in the full amount of its trade indebtedness, even though by definition of bankruptcy the full amount was not likely to be paid, and petitioner has apparently made no effort to treat income items by accrual methods.

2. If petitioner remained on a cash basis, the transfer of its assets to the trustees in bankruptcy in and of itself did not liquidate, and therefore did not constitute payment of the petitioner's indebtedness. A trustee in bankruptcy is not, as petitioner would have it (Pet. 5–12, 21–22, 23, 26–30), essentially a collection agent for the creditors. The trustee is an officer of and acts for the court. He must protect the interests of the bankrupt as well as compute the dividends of the creditors. *E.g., Callaghan* v. *Reconstruction Finance Corp.*, 297 U.S. 464, 468: see 2 Remington on Bankruptcy, Section 1117 (1956 ed.). Moreover, at the time the assets were turned over to the trustees, there was no certainty that any set amount would ultimately be used in liquidation of petitioner's debts, for various then undetermined expenses, such as those of administration of the bankrupt estate, take priority over claims of unsecured creditors. Nor was there certainty as to which creditors would file timely and valid proofs of claim, and which assets could be applied in payment.

Therefore, petitioner's transfer of assets placed him in no different position than a taxpayer who transfers assets to another party who assumes, but does not then pay, the taxpayer's business liabilities. Such a transferor cannot deduct the assumed but unpaid liabilities, and neither may petitioner. *Doggett* v. *Commissioner*, 275 F. 2d 823 (C.A. 4); *Citizens Nat. Trust & Savings Bank* v. *Welch*, 119 F. 2d 717 (C.A. 9); *Kniffen* v. *Commissioner*, 39 T.C. 553.

For like reasons there is no merit to petitioner's claim (Pet. 13, 22) that the transfer of its assets was

a deductible loss under Section 165(a) of the 1954 Code. A loss can be deducted only if the taxpayer sustained a specific identifiable loss of assets through a transaction that is closed and completed during the taxable year. See *United States* v. *White Dental Co.*, 274 U.S. 398, 401; Treasury Regulations on Income Tax (1954 Code), Section 1.165–1 (b) and (d) (1). The transfer of assets to a bankruptcy trustee is not a closed or completed transaction evidencing a loss. No loss can occur before the trustee applies the transferred assets in payment of the bankrupt's debts after proofs of claims have been filed and allowed. I.T. 2898, XIV–1 Cum. Bull. 70 (1935).

But even then, there is no logic in finding a loss where a bankrupt receives a discharge of his debts in exchange for his assets. *Stuart* v. *Commissioner*, 38 B.T.A. 1147, should not lead to a contrary conclusion. *Stuart* did allow a loss deduction where a judgment was rendered against a taxpayer, who then filed a voluntary petition in bankruptcy and turned over all his property to the trustee. As the district court correctly noted here (R. 81), "the *Stuart* case is directly contrary to the overwhelming weight of authority on this point". Moreover, three years after *Stuart* was decided the Board of Tax Appeals in *Parkford* v. *Commissioner*, 45 B.T.A. 461, 471–472, affirmed, 133 F. 2d 249, 251 (C.A. 9), certiorari denied, 319 U.S. 741, restricted *Stuart* to its facts and held that there is no deductible loss "when, through the bankruptcy proceedings, he was discharged from liabilities greatly in excess of the actual cost—and basis—of the property which he turned over." 45

B.T.A. at 472. See also, *Cooney* v. *Commissioner*, decided December 22, 1942 (P-H Memo T.C., par. 42,670); *Marlowe* v. *Commissioner*, decided January 27, 1967 (P-H Memo T.C., par. 67012). As the Ninth Circuit stated in affirming *Parkford*, in reasoning equally applicable here, "If [the bankrupt] had voluntarily compromised his [debts] with his creditors by an assignment of his assets he could hardly assert a deductible loss. We perceive no reason why he may do so in the present circumstances." 133 F. 2d at 251.

3. There is no merit to petitioner's final contention (Pet. 13-15, 25-26, 30-36), that the termination of its operations resulted in the loss of usefulness of its packing plant and machinery and entitled it to a loss for obsolescence under Sections 165 and 167 of the 1954 Code. Since the assets were depreciable, any deduction in excess of normal depreciation is governed by Section 167 of the 1954 Code and not by Section 165. See Treasury Regulations on Income Tax (1954 Code), Section 1.165-2.

Section 1.167(a)-8 of the Regulations allows such a "retirement" deduction upon the sale, exchange, or physical abandonment of an asset. In the present case petitioners concede (R. 23) that the packing house and machinery were neither sold nor physically abandoned in the 1959 tax year, but were transferred to the trustees and later sold by them to third parties (R. 23, 31). Thus, petitioner sustained no obsolescence loss that year. See *United California Bank* v. *Commissioner*, 41 T.C. 437, affirmed *per curiam*, 340 F. 2d 320 (C.A. 9); *In re Rae's Estate*, 147 F. 2d 204 (C.A.

3); *Commissioner* v. *McCarthy*, 129 F. 2d 84 (C.A. 7).

Section 1.167(a)–9 of the Regulations entitles a taxpayer to a loss deduction only if there was an abnormal retirement of assets under circumstances whereby they have been damaged by casualty or suddenly became obsolete in the sense of sudden functional or economic uselessness. See *Real Estate Title Co.* v. *United States*, 309 U.S. 13; *United California Bank* v. *Commissioner, supra.* Petitioners have not shown any such loss of usefulness and the trustees' subsequent sale of the packing house and machinery as part of a package sale of petitioner's assets directly refutes the claim of obsolescence.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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